Business

ENTITY-PURCHASE BUY-SELL AGREEMENT

Presented for

Sample Company

Presented by

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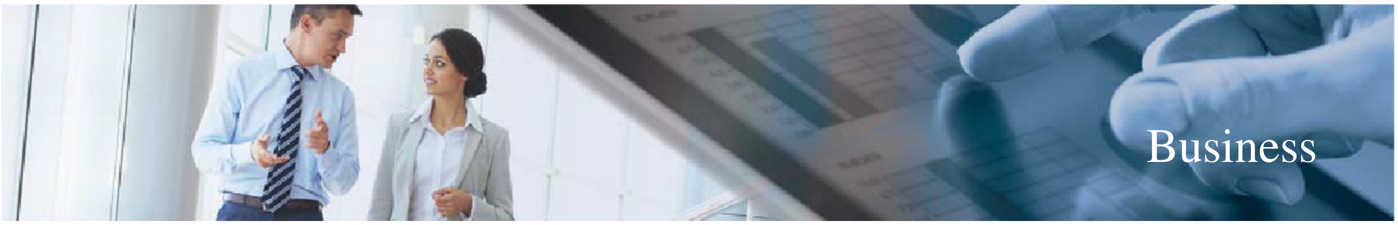


ENTITY-PURCHASE BUY-SELL AGREEMENT

The Concept…

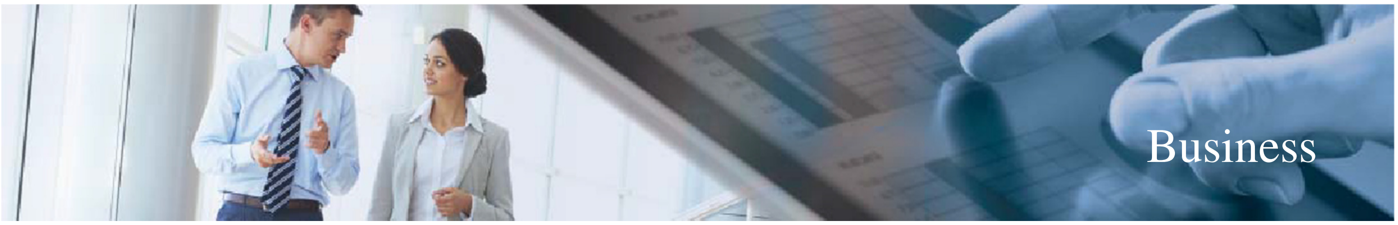
- A buy-sell agreement is an efficient means of ensuring a smooth transition of ownership after a potentially disruptive event—an owner's retirement, incapacity or death.
- This legally binding contract establishes under what conditions and at what price an owner (or more often, a deceased owner's heirs) must sell a business interest to the business entity.

The Process…

- Under an entity buy-sell agreement, the business entity agrees to buy a deceased owner's interest and the estate agrees to sell at an agreed-upon purchase price.
- An entity buy-sell agreement is funded with life insurance purchased by the business on the life of each owner. The amount of insurance approximates the purchase price for each insured's share of the business.
- Each owner agrees to allow the business to purchase a specified amount of life insurance on the owner's life and the business secures each owner's written consent.
- The purchase price is either specified as a certain amount, or as a formula that will be used to establish the price.
- The business entity owns and is the beneficiary of the policies. If an owner dies, the business receives the life insurance proceeds, which are used to purchase the deceased owner's interest.

The Choice…

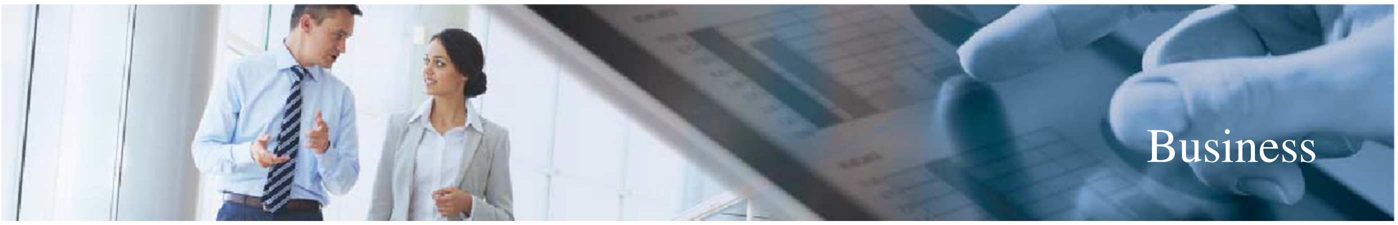
- There are two additional types of buy-sell agreements. A **cross-purchase agreement** specifies that each owner individually agrees to buy a portion of the deceased owner's interest. A **one-way agreement** specifies a potential buyer (e.g., a key employee) who has agreed to buy the business interest.
- An entity agreement is preferred over a cross-purchase agreement when there are a number of owners. Under an entity agreement, the business purchases one policy for each owner. Alternatively, under a cross-purchase agreement, each owner is required to purchase a policy on every other owner.



- Entity agreements are also preferred when there is a wide disparity in the owners' ages. With a cross-purchase agreement, younger owners bear a greater premium burden for policies on older owners.
- A business may also choose an entity agreement to gain access to policy cash values. Cash value access is not generally available under a cross-purchase agreement.

The Tax Consequences…

- Premiums paid for life insurance to fund a buy-sell agreement are not tax deductible; however, the death proceeds are generally excluded from federal income tax when the notice and consent requirements have been met.
- C corporations may be subject to the corporate alternative minimum tax on part of the insurance proceeds because the "inside buildup" (cash in excess of the cost of insurance) is included in the AMT calculation.
- If a corporate stock redemption agreement is used, there generally is no increase in basis for a surviving owner's interest (as there is with a cross-purchase agreement).
- Distributions from a corporation to a shareholder are taxed as dividends unless the stock redemption qualifies as an exempted transaction, such as a Section 303 redemption or a complete termination of the shareholder's interest.
- The price established for a business interest in a buy-sell agreement can fix the value for federal estate tax purposes when strict legal requirements are met.
- The agreement can base the price on a professional appraisal or on a formula that considers:
  - the company's earnings history along with future earnings potential
  - the book value of the company's assets
  - the general financial condition of the business
  - any prior sales of a business interest
  - goodwill
  - the outlook for the specific industry and the economy in general

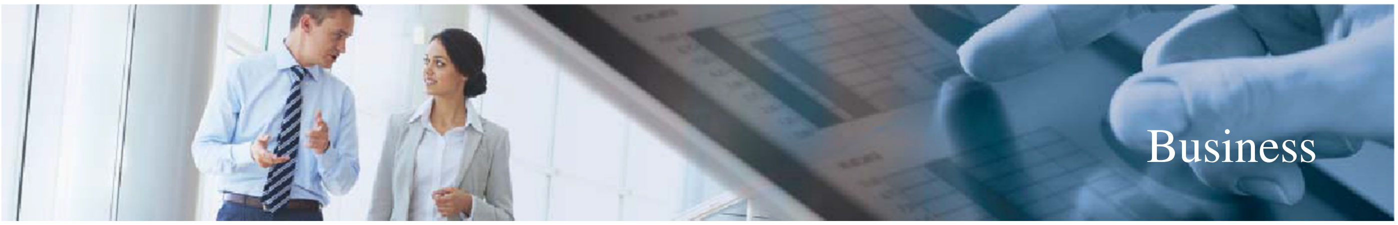


The Bottom Line…

A buy-sell agreement adequately funded with life insurance can be an invaluable tool in solving three pressing problems:

- Establishing a price for the business interest
- Securing a buyer
- Ensuring that the money to purchase that interest will be there when it is needed.

Choosing the type of agreement—entity, cross-purchase or one-way—depends on the characteristics of the business and the owners' wishes.



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SUMMARY

What Is a Buy-Sell Agreement?

A buy-sell agreement is a legally binding contract that establishes the circumstances under which the sale of a business interest will occur (an owner's death, disability or retirement), who will purchase the business (typically the business itself or the other owners), and the valuation method to be used at the time of the sale. An entity buy-sell agreement provides that the business will buy a deceased owner's interest.

There are two additional types of buyouts. A cross-purchase agreement provides that each surviving owner purchase a portion of the deceased owner's interest, and a one-way agreement can be used by a sole owner to identify a potential buyer, such as a key employee.

Why Is an Agreement Needed?

A buy-sell agreement helps ensure that a business will continue after an owner dies. When adequately funded with life insurance, the agreement ensures that control of the business will remain with the surviving owners and that the heirs will receive a fair price for their interest.

How Does an Entity Buyout Work?

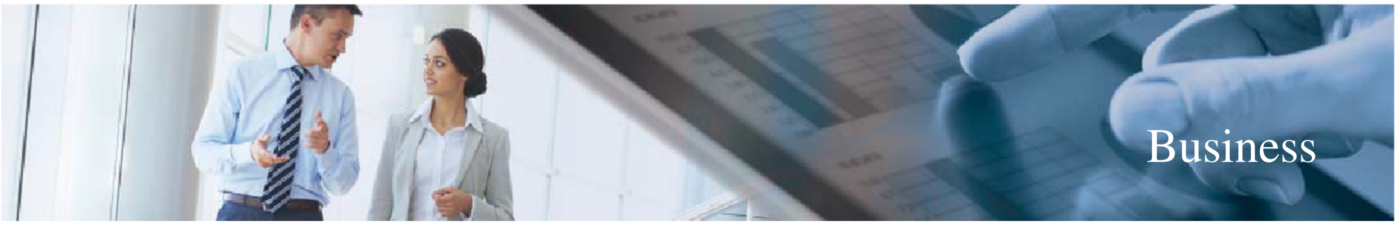
To provide funding for the buyout, the business purchases life insurance on each owner, with the business entity as the owner and beneficiary of each policy. The business must give notice that it intends to insure the owner-employees and must also secure each owner-employee's written consent.

The amount of insurance approximates the agreed-upon purchase price for each owner's interest. The agreement stipulates either a specific purchase price or a formula for determining the purchase price. Life insurance proceeds provide the funds to buy the deceased owner's interest.

Although premiums paid for the insurance are not tax deductible, death benefits are generally excluded from federal income tax when the notice and consent requirements have been met. C corporations may be subject to the corporate alternative minimum tax on part of the policy proceeds. Redemptions that meet certain requirements can avoid being taxed as dividend distributions.

When Is an Entity Agreement Preferred?

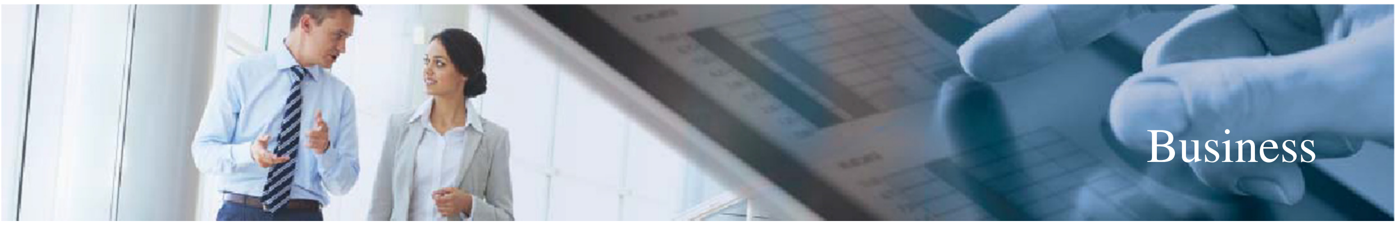
An entity buy-sell agreement is preferable when there are many owners, since this arrangement requires that the business purchase only one policy on each owner. A cross-purchase agreement requires that every owner buy a policy on every other owner. An entity agreement may also be preferred when there is a wide age disparity among the owners, since younger owners would bear a greater premium burden to insure older owners under a cross-purchase agreement. If the business wants access to policy cash values, the business must own the policy. This is not possible in a cross-purchase agreement, where individuals are the policy owners.



What Are the Benefits?

With an entity buy-sell agreement adequately funded with life insurance, the business is assured the funds are available to buy out a deceased owner. The surviving business owners maintain control of the business and the deceased owner’s estate will be provided needed liquidity for expenses and taxes. All the terms of the sale—the purchase price, when the purchase will occur and funding arrangements—are decided in advance. In addition, a properly drawn agreement can fix the value of the business interest for federal estate tax purposes.

When written agreements are made in advance and adequate funding is in place, the benefits are substantial. By setting a fair price for the business interest and establishing a willing seller and a willing buyer with the needed liquidity to make the purchase, owners can be confident of a seamless transfer when the time comes.



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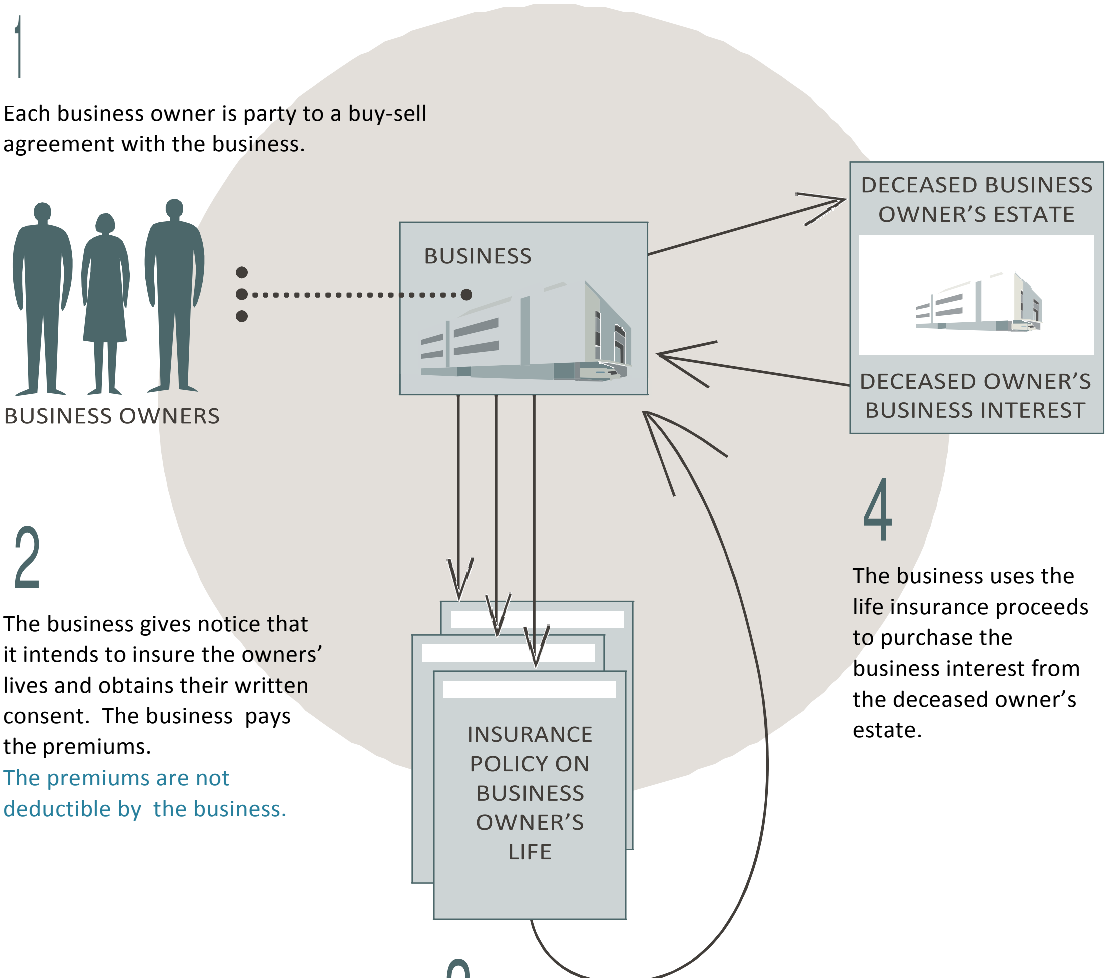


1

Each business owner is party to a buy-sell agreement with the business.

2

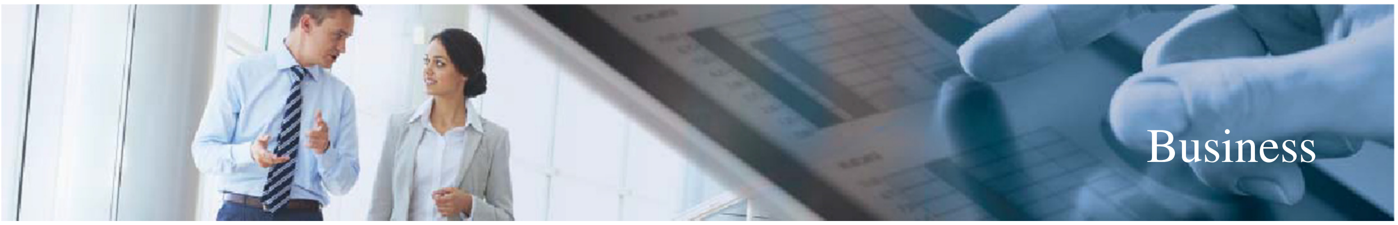
The business gives notice that it intends to insure the owners' lives and obtains their written consent. The business pays the premiums.
The premiums are not deductible by the business.

3

When an owner dies, the business (as beneficiary) receives the death benefit from the policy insuring the deceased owner's life.

4

The business uses the life insurance proceeds to purchase the business interest from the deceased owner's estate.



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